Isle of Man Wealth and Fund Services Association
Practice Note – Deferred Sales Charges

1 Introduction

1.1 The Isle of Man Wealth and Fund Services Association acts as the representative body for the Island's wealth management and fund services sector. The Association exists primarily to further the interests of members firms and its activities include providing focused training to member firms and representing the industry in respect of legal, regulatory and fiscal changes designed to encourage the growth and development of the sector on the Island. The Association also seeks to provide practical advice to member firms regarding emerging industry issues.

1.2 The purpose of this Practice Note is to provide member firms with guidance regarding Isle of Man funds which are structured with Deferred Sales Charges ("DSC"). This Practice Note is intended solely to provide guidance and does not have any mandatory force; it is, however, hoped that member firms involved in fund establishment, promotion, management or administration will find this Practice Note of assistance.

2 Background

2.1 A number of funds managed or administered in the Isle of Man have been set up with DSC as part of their charging structure. (These charges are also sometimes called 'deferred subscription charges', 'deferred initial charges', 'back end loading' or 'marketing sales fees'.).

2.2 For dealing net asset value ("NAV") purposes, the charge is capitalised and then amortised to profit and loss account over a fixed period (commonly 5 years). An exit penalty is also usually established, so that ongoing investors are not disadvantaged by redeeming shareholders – with the exit penalty being equal to, or greater than the value of the unamortised DSC. For financial statement purposes the unamortised DSCs are generally written off immediately, as they do not meet the definition of an asset under Generally Accepted Accounting Practice ("GAAP").

2.3 The use of a DSC may create inequalities for individual shareholders if that investor stays invested beyond their amortisation period – as after this date they will bear part of the amortisation of other investors who subscribed at a later date and this may be materially dependent on timings of cash flows into the fund.

3 Recommendations

3.1 Risk Warning

3.1.1 A risk warning should be included in all marketing material in relation to a fund that uses a DSC.

3.1.2 It is primarily a matter for the manager or administrator and the governing body of each existing fund or prospective fund that uses a DSC to consider whether they are satisfied that the disclosures/risk warnings contained in the offering document and any marketing material and/or any subsequent disclosures included in the financial statements of the fund, are adequate to ensure that all investors are fully aware of the charging structure and any potential material inequity that may arise between investors due to the existence of a DSC, once the amortisation period has been completed. It may be decided to establish a "low charge share class", with no DSC, into which shareholders that have completed their amortisation period will be transferred in order to seek to eliminate or minimise any possible material inequity.

3.1.3 It is important that all marketing material gives equal prominence to the existence of the DSC as it does to the level of initial charges and the percentage allocation of units, as well as on-going charges.

3.2 New funds

3.2.1 The board of directors of the fund's governing body ("Directors"), the promoter (if any) and the manager or administrator should consider whether a form of equalisation, series accounting or the creation of a low charge share class at the end of amortisation periods will be operated to address the potential inequities between individual shareholder returns which may arise by using a DSC.

3.2.2 In the event that the Directors, the promoter (if any) and the manager or administrator decide not to use equalisation, series accounting or the creation of a low charge share class, but have identified that potential inequalities may arise, they should ensure that the existence of these potential inequalities are clearly described in the offering document and any marketing literature produced for the fund. All decisions should be fully documented.

3.2.3 The audited financial statements should include a reconciliation of the NAV calculated for dealing purposes and the NAV disclosed by the financial statements.

3.3 Existing funds

3.3.1 Fund managers and administrators should identify which funds they manage or administer that use a DSC. Managers and administrators should request that the Directors of funds that use a DSC formally consider the issues arising, in the context of this Practice Note, and agree if any actions are required. All decisions should be fully documented.

3.3.2 The Directors should review the disclosures contained in the fund's offering document and constitutional documents, together with any marketing material in respect of the fund, to ensure that all investors are aware of the potential inequity that may arise between investors due to the existence of a DSC. If, in the opinion of the governing body, the disclosures in the current scheme documentation/marketing material are deficient, these should be amended as appropriate and any material changes communicated to existing shareholders when appropriate.

3.3.3 The Directors should also ensure that appropriate disclosure is included within the audited financial statements issued to shareholders regarding the level of amortised and unamortised DSC. The audited financial statements should include a reconciliation of the NAV calculated for dealing purposes and the NAV disclosed by the financial statements.

3.3.4 As previously noted, the greatest potential impact on any individual shareholder occurs if that investor stays invested beyond their amortisation period. Where deemed appropriate, Directors may consider establishing a low charge share class with no DSC into which shareholders that have completed their amortisation period will be transferred.

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